THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 386 **AUGUST 2005**

The thing which is needed to secure healthy economic conditions is the most speedy and complete adaptation possible of the structure of production to the proportion between the demand for consumers' goods and the demand for producers' goods as determined by voluntary saving and spending. If the proportion as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand, it must mean that part of the available resources is again led into a wrong direction and a definite and lasting adjustment is again postponed.

Friedrich A. Hayek, *Prices and Production*, 1931

GLOBAL REALITY CHECK

On June 20, the Swedish central bank surprised the markets with a drastic cut of its repurchasing rate from 2% to 1.5%, slashing its growth forecast for 2005 from 3.2% to 1.9%. In its related statement, the bank admitted that recent economic data were much weaker than it had expected. A government speaker made the point that the Riksbank had totally misjudged the economy's performance. Like other central banks, it had discarded earlier softening data as merely a soft spot.

Evidence of sharply slowing economic growth is, actually, accumulating by the week for two other economies — Britain and Australia, both belonging to the Anglo-Saxon family of housing bubble economies. Flattened house prices in both countries have drastically curbed home equity withdrawal, essentially with prompt, drastic adverse effects on retail sales.

In the United States, the housing bubble still appears to be pretty hot. With some amazement, though, we have read that some stronger economic data for June mark the end of the economy's mild soft patch in the second quarter. We note a striking difference on the part of American policymakers and economists in weighing soft and strong economic data, associated with an outstanding laxity in looking below the headline data.

A typical case was the great attention paid to the first upward move of the Institute for Supply Management manufacturing index after a long uninterrupted decline. While the prolonged prior fall had captured little or no interest, its first uptick was immediately hailed as the turning point.

Moreover we must confess to having very little esteem for the extensive use of surveys in America to explore economic prospects by querying a number of people about their sentiment and expectations. Most of them, of course, just echo the tone in the media, which is heavily influenced in the United States in favor of optimism. There is nothing like that in Europe.

In the end, future spending by businesses or consumers is determined by underlying objective economic and financial conditions. Numerous Wall Street economists, acting as shills for the market, will keep up their "stronger growth is just around the corner" hype regardless of any and all evidence to the contrary. There are far too few critical voices.

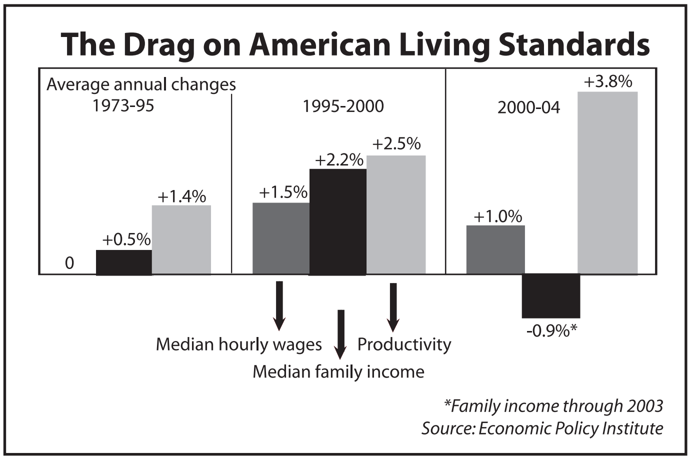
In our opinion, it is the economist's prominent and explicit task to form his personal judgment through careful research of the important economic and financial facts, provided he has the knowledge to distinguish them. Such research, therefore, requires something else in addition. To quote Friedrich A. Hayek: *"On the whole, one can say without exaggeration that the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based."*

What is currently the most important fact about the U.S. economy? In short, an unprecedented, tremendous divergence between GDP and income growth. GDP growth has been driven by understated inflation rates and

the combination of the housing and credit bubble, both being propelled by ultra-cheap and ultra-loose credit. But income creation from production is grossly lacking.

In the consensus view, government policies were immensely successful in achieving an unusually mild recession. We have always disputed this positive assessment.

Any such judgment ought to include the performance of the following recovery. Taking that into account, the U.S. economy's performance was by far its weakest of the whole postwar period. Measured by employment and wage and salary income, it was a disaster.



In real terms, average gross weekly earnings are barely higher than in 2000.

Given minimal employment growth, it turns out that for the American public there never was an economic recovery over the past few years. To increase the family's living standard, higher borrowing was generally required, which was done with abandon.

Now to the U.S. economy's grossly imbalanced economic growth since 2000: real GDP, +13%; consumption, +15%; residential building, +31%; government, +13%; business fixed investment, +5.6% (due to hedonic pricing of computers); current-account deficit, +81%.

With this knowledge in mind, a pivotal question arises: Is this shortfall in employment and income generation on the mend or not? If not, it is high time to investigate the major cause or causes of this anomaly.

U.S. POTEMKIN VILLAGES

In this U.S. recovery, 2004 was the first year of job growth in every month. In total, the economy created 2.2 million new jobs. Yet this was nearly 40% short of the job creation that has been average for this stage of the recovery. This benchmark was used in early 2004 when the Bush administration forecast that 3.6 million jobs would be created from December 2003 to December 2004. Ominously, this was also the first year, in which wages rates fell on average relative to inflation.

Some 3.5 million individuals exhausted their regular unemployment benefits before they could find a new job. After six months out of work, the worker loses these benefits.

There was definitely no breakthrough on the employment front in 2004. Rather, the discrepancy in job creation to past cyclical recoveries keeps widening. Courtesy of giant statistical assistance from the net birth/death model, the current year again had a fairly good start. Yet recent employment data show new, significant weakness.

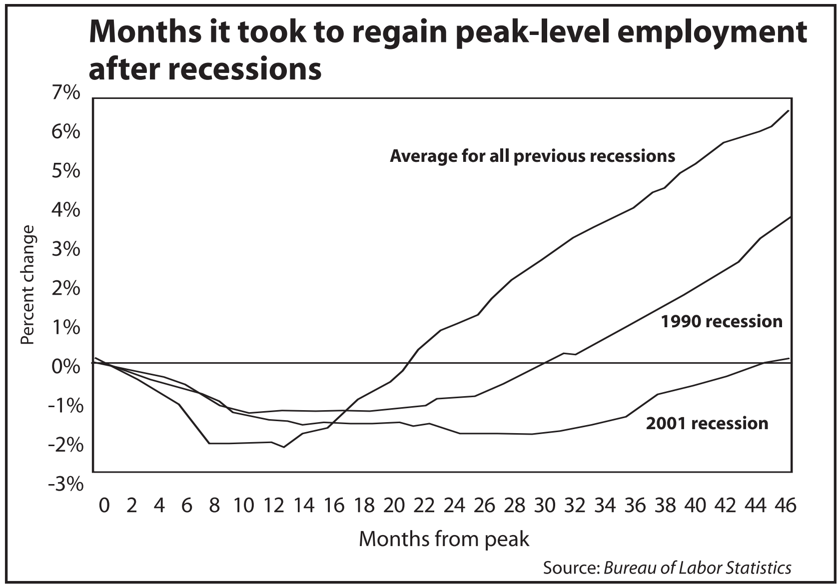
Of course, it finds no publicity that America's job performance since 2000 is the worst in the world, far worse than in the Eurozone. Like the U.S. Bureau of Labor Statistics, Eurostat, Europe's equivalent, captures changes both in employment and unemployment. Only the latter — though, up 1.4 million from 7.8% to 9% over this period — gets regular publicity. Positive changes in employment — up about 3.5 million since 2000 — are published, but publicity is nil.

The relevant facts are these: In Europe, labor participation is outpacing unemployment, but the public focus is exclusively on the negative numbers of the latter. In the United States, participation is falling faster than unemployment, but the focus is exclusively on the better-looking, heavily flattered unemployment numbers.

Our flagrant disagreement with the bullish consensus view about the U.S. economy's health and

performance has its reason in the fact that we focus on entirely different features and aggregates as crucial measures of economic performance.

The view of a "New Paradigm" U.S. economy fixates predominantly on three criterions: the low inflation rate, and strong GDP and productivity numbers. It is categorically supposed that their conjunction is compelling proof of the economy's new, superior efficiency.



It is true that these three aggregates have traditionally played a key role in assessing an economy's performance. GDP and productivity growth were, in essence, understood as proxies for employment and income growth, while a low inflation rate was appreciated as the hallmark of sound monetary policy and efficient markets.

According to long postwar experience, these appraisals were perfectly reasonable. But any discerning observer ought to have recognized by now that the former close relationship between GDP or productivity growth and income growth has broken down in the past 10 – 20 years.

Just look at the chart on page 2, "The Drag on American Living Standards." The horrendous discrepancy between falling median family real income growth and record-high productivity growth is preposterous. Compared with this extremely poor income growth, both GDP and productivity have clearly become the most worthless and overrated aggregates of the major U.S. economic reports. It should require no particular explanation that America's economic reality is in the dismal employment and income figures.

It has to be realized that for most families the economic reality is considerably worse than even this chart indicates, because the reported real income growth benefits heavily from the grossly understated inflation rates in the same way as the reported numbers for real GDP and productivity growth. Pondering the many well-known expedients with which the BLS betters the reported inflation rates, we estimate it is understated by about at least two percentage points.

Unusual things are also happening, by international comparison, to the unemployment and employment numbers. Altogether, there are five or six different indicators. Just one is reading green — the unemployment rate. Although everybody knows of its big distortion through "discouraged workers," it enjoys great publicity. Millions of Americans who have lost their jobs are not counted as unemployed unless they admit to be actively looking for work. They simply vanish as declining participation. Expert estimates put the hidden unemployment on this account at up to 5 million.

Another built-in conveyor of good-looking economic news is, of course, the BLS' net birth/death ratio. Reported private sector jobs are only 103,000 above the December 2000 peak. From the recession trough in 2001, private jobs have increased 2.2 million, compared with average gains of 7.2 million in previous postwar recoveries.

But now consider that during this recovery the net birth/death model has so far accounted for more than 1.5 million new private jobs. The declared idea behind it is to "capture, on a timely basis, employment growth generated by new business formations," derived from the experience of past recoveries.

In a comment to this model, the BLS freely admits that *"the most significant potential drawback to this or any model-based approach is that time series modeling assumes a predictable continuation of historical patterns and relationships and therefore is likely to have some difficulty producing reliable estimates at turning points or during periods when there are sudden changes in trend."* Understandably, they express this obligatory reservation

rather mildly.

However, considering that job creation has virtually collapsed during the present recovery, the BLS' obvious assumption that the level of new business formations has proceeded at the high level of past experience is truly bizarre. Bear in mind, please, that these phantom jobs add to the calculated income growth.

Long ago, we came to the conclusion that the good-looking numbers about the U.S. economy over the past few years largely originated in the Bureau of Labor Statistics rather than in the economy. It is the enormity of these statistical "refinements" that must shock. All of a sudden, it hit us: This is like the "Potemkin" villages of cardboard that Grigori Potemkin built in the Ukraine in the late 18th century to delude Catherine II about the state of the area.

ANGLO-SAXON WEALTH ILLUSIONS

Reading many reports about virulent house price inflation around the world, it seems to us an urgent necessity to stress one crucial difference between countries that is, in general, not fully appreciated. With few exceptions, mainly Japan and Germany, the house price bubble is, indeed, occurring on global scale.

Yet the most important feature of asset bubbles has not gone global. That is the practice of extracting huge sums of money from the family home on account of rising house prices. This is mainly an Anglo-Saxon specialty.

In this respect, France is the most striking case. Although house prices have been rising at double-digit rates for years, equity withdrawal has been nonexistent. Even though mortgages are much cheaper in France than in any Anglo-Saxon country, French households stubbornly stick to their traditional savings rate of a little over 10% of their disposable income.

The key point to see here is that France has a pure housing bubble, bare of any effect on the economy. The absence of equity withdrawal means the absence of a bubble economy. This is the imperative contrast to the Anglo-Saxon economies. Their heavy mortgage equity withdrawal qualifies them as perfect "bubble economies."

For many Anglo-Saxon commentators, this widespread abstinence from equity withdrawal on the basis of inflating house prices is just another example of European inflexibility. To us, this judgment again reveals total ignorance about Europe.

The fact is, contrary to the prevailing perception in Anglo-Saxon countries, public opinion in Europe does not appreciate asset price inflation as valid "wealth creation." That is true of the people, and it is equally true of the bankers. Characteristically, the subject of house prices rarely props up in the media. Public interest is nil.

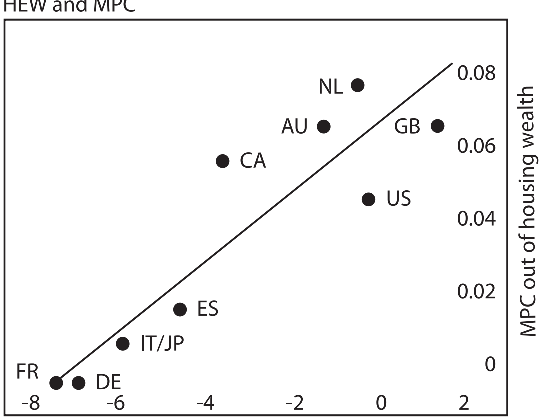
We categorically share this view. Plainly, rising house prices add nothing real for the homeowners. What it truly creates in the Anglo-Saxon countries is additional borrowing facilities. But we should not equate this with wealth creation.

Is this a case of typical European inflexibility? To us, it is a case of typical European down-to-earth economic sanity. Any serious-minded economist ought to be aware that this new wealth from rising house prices is in reality no more than a bookkeeping item, lacking any true economic gain for the owner or the nation.

Plainly in the Anglo-Saxon countries, the phony wealth effects derived from rising house prices have become the key support of their economic growth. That is

Housing Equity Withdrawl

HEW and MPC[1]



HEW (average 1990-2002)

AU=Australia; CA=Canada; DE=Germany; ES=Spain; FR=France; JP=Japan; NL=Netherlands; US=United States

HEW = housing equity withdrawl, expressed as a percentage of disposable income; MPC = marginal propensity to consume.

Sources: Bank for International Settlements, 75th Annual Report

what policymakers like about it, masquerading it as the exemplary, superior Anglo-Saxon model.

To us, all the fuss about soaring wealth creation represents a deliberate delusion of the public about the dismal economic reality in some of these countries. The only real thing is the skyrocketing unproductive indebtedness borrowing from sluggishly growing future income.

The soaring debt levels are the one long-term problem of these policies. From the macro perspective, the other one is a major, unsustainable displacement in the allocation of their resources. As bubble-driven consumption absorbs a growing share of GDP, other components have to yield. The yielding components in all Anglo-Saxon countries are business fixed investment and the foreign trade balance.

Huge, chronic current-account deficits are the spectacular hallmark of the Anglo-Saxon economies. As a percentage of GDP, the deficits in 2004 amounted as follows: Australia, 6.3%; New Zealand, 6.3%; United Kingdom, 2.2%; United States, 5.7%. Canada is the only exception with a surplus, certainly due to its large trade with the United States. Britain, of course, benefits from its oil.

Observing the unbelievable borrowing spree of the American consumer, we keep asking ourselves about the true underlying motives or causes. Is it an unprecedented thirst for luxury? Or is it a necessity for most people to maintain their living standard? We have no doubt that it is overwhelmingly the latter.

SHOCKING U.S. EMPLOYMENT AND INCOME NUMBERS

With its huge trade deficit, the U.S. economy has become an important pacesetter for the world economy. Consumer surveys, most economic reports and the ebullient stock markets are conveying the impression that it is gaining new steam. Arguments in this sense abound. Goldilocks is the new catchword on Wall Street. But all the numbers that are quoted for proof strike us as being extremely lightweight.

The decisive shortfall of the U.S. economy in this recovery, as we have emphasized many times, is its dismal employment and income performance. Logically, that is where we have to look for fundamental improvement.

During the first half of 2005, non-farm payrolls have gained 1.112 million, of which

647,000 were courtesy of the net birth/death model. Is that bad or good?

Compared with a gain of 1.48 million in the first half of last year, with a similar contribution from the net birth/death ratio, this represents a drastic deterioration. In 2004, this phantom component accounted for less than half of the reported job creation. In recent months, it has accounted for well over 100%. Also important, manufacturing remains a constant job loser.

For a comprehensive economic picture, we regularly focus on the monthly *Personal Incomes and Outlays* reports of the Bureau of Economic Analysis (BEA). The following numbers give some food for thought.

Growth of Consumer Expenditures (in billion chained dollars)

2003*	2004*	2004			2005				
		Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
19.3	23.1	16.7	15.3	72.3	–15.4	32.0	28.6	18.1	–3.0

Growth of Real Disposable Income of Private Households (in billion dollars)

14.5*	23.8*	26.6	51.3	356.5	–299.2	21.3	1.1	4.4	10.9

* monthly average

Source: Bureau of Economic Analysis, Personal Income and Outlays

According to these official figures, both personal spending and income growth have sharply lost momentum in recent months. The steep plunge in real income growth is the most ominous, apparently reflecting the worsening employment figures. How can anybody speak of economic resurgence in the face of these disastrous figures? In short, their eyes are on the spending uptick in June.

STILL MORE STRUCTURAL DEFORMATION

Hayek's quote on the first page, which we regard as most important, states that a return to healthy economic growth is contingent upon a most speedy and complete restoration of the normal relationship between consumption, saving and investment. In the Anglo-Saxon countries, the diametric opposite has been happening since 2000.

Measured by aggregate real GDP growth, they have markedly outperformed the economies of the Eurozone in the past few years, as policymakers and many economists in these countries triumphantly boast. The conventional explanation is better policies, more efficient markets and better corporate governance. Even policymakers and economists in Europe readily believe this trash.

Finally, we come to the fundamental reasons for our bearish assessment of the economic development primarily in the United States. It is rooted in stringent macroeconomic analysis, focusing on major changes in the allocation of resources and the composition of economic growth.

Possessing the most efficient markets is especially a favorite argument in the United States. Certainly referring to the U.S. economy, Fed Chairman Alan Greenspan once expressed the view *"that in economies approaching full flexibility, imbalances are likely to be adjusted well before they become potentially destabilizing."*

We can only marvel at such naivete. In an economy being flooded with unprecedented credit excess, the mere idea of efficient markets is ludicrous. There must be gross mispricing all-over such an economy and its financial system. U.S. markets are unquestionably extremely efficient in a technical sense, but from the perspective of proper pricing, they are complete misfits.

What drives them is definitely not saving; it is the greatest credit excess in history with financial leverage that has shifted from parabolic to almost vertical. Obvious interventions in the stock market have become more numerous. At the same time, Asian central banks rigorously manipulate the dollar. Also think of the heavily manipulated price indexes and job figures, both strongly influencing the markets.

CAPITAL CONSUMPTION INSTEAD OF CAPITAL FORMATION

Let us look at the U.S. economy's atrocious pattern of growth since 2000. Basically, private households, taken together, determine through their saving from current income the distribution of resources between current consumption and investment for the future. As a result, all economies develop a "desired" consumption-savings-investment pattern to which its production structure implicitly adjusts. This really is the fundamental insight from which the Austrian thinking about dangerous structural imbalances starts.

Anglo-Saxon countries have typically high rate of consumption and low rates of saving and capital investment. It used to be the common view that for the longer term they needed higher rates of the latter. But since 2000 the development has gone dramatically into the opposite direction.

In the United States over the last four years, 2000–04, consumer spending on goods, services and housing has accounted for 98.2% of real GDP growth. Over the long run, this would be around 70% of GDP. Government spending contributed another 21.9%. Business fixed investment in 2004was barely higher than in 2000. National savings — normally 7–8% of GDP — have collapsed close to zero, while the current-account deficit has escalated from $413 billion to close to $800 billion recently.

Does it matter when people in a country boost their current consumption by depleting their savings, investments and trade balance? It is really a shame that this question has to be asked. Imperatively, it means depleting wealth. In "Austrian" jargon, this is capital consumption.

But public opinion in the Anglo-Saxon countries completely fails to realize this general impoverishment because the house price inflation, engineered by cheap and loose credit, instead conveys the illusion of rampant wealth creation.

THE CRUCIAL SHORTFALLS

Apparently, one cannot stress often enough that the U.S. recovery from the 2001 recession has its crucial shortfalls in employment and associated wage and salary attrition. One would think this would have spurred a lively discussion about its cause or causes. We note only silence on this issue. But what is causing them?

A glance at the GDP data gives a ready answer. They show two big gaps in the U.S. economy's grossly imbalanced growth pattern: the monstrous trade deficit and unusual weakness in business fixed investment.

Starting with the trade deficit, it has cost the U.S. manufacturing sector several million generally high-paying jobs since the late 1990s.

It is a convenient story that the U.S. manufacturing sector's misery is largely due to a major shift in domestic demand towards services. The truth is that a rapidly growing share is met by foreign producers.

Foreign trade is virtually all in manufactured goods. That is the first clue to realize. The second one is that the soaring U.S. trade deficit reflects an unprecedented and growing divergence between domestic demand and output in manufacturing. Imports are taking a rapidly growing share of domestic spending, while the share of domestic output is falling to ever-new lows. In short, U.S. manufacturing is being remorselessly hollowed out for the benefit of cheap imports.

The stereotypical, complacent answer is that all countries benefit more or less equally from globalization. This is true, but under one specific condition only — balanced trade. With a little logic, it ought to be easily realized that a huge, chronic import surplus inexorably corroded manufacturing. The obvious basic fact is that the U.S. economy — and in line all Anglo-Saxon economies — is rapidly losing ground in global competition.

This still leaves us with the most important question of all: Why are such perennial, huge trade deficits specific to the Anglo-Saxon countries? The favorite explanation on their part is higher growth than in the rest of the world. That is true in relation to the Eurozone, but it is not at all true in the case of China and East Asia. Despite much faster economic growth, they all are running chronic, large trade surpluses.

Extensive experience and old-fashioned macro theory offer a ready answer. Trade deficits typically reflect the fact that consumer spending in the countries concerned is rising out of proportion to business fixed investment. Domestic demand is outpacing domestic supply. Deficit countries have low rates of savings and investment but high shares of consumption. The three happen to be the economic emblems of all Anglo-Saxon countries.

This brings us to the second crucial shortfall of the U.S. economic recovery: badly lagging business fixed investment.

Here, the decisive point to see is that business fixed investment is of vital importance for economic growth. Self-sustaining growth, in fact, depends crucially on a sufficiently strong contribution from business fixed investment. To American policymakers and most economists, who are just counting beans, this is apparently unknown.

Business fixed investment owes its outstanding importance for economic growth to two main reasons: *first*, it involves extensive use of labor and materials; and *second*, it has — through following depreciations and reinvestment — cumulative demand and income effects far into the future. There is therefore no substitute for lacking business investment.

Sharply declining business fixed investment was crucial for the economic downturn in the industrialized countries as a whole during 2000–01. The problem is that — again, generally — it has failed to recover in sufficient strength.

HOUSING BUBBLES — THE DANGEROUS SPECIES

We come to the crucial difference between the Anglo-Saxon and Eurozone countries. With extremely loose money, the former have chosen a way leading to bubble economies, in which house price inflation has delivered the collateral for unprecedented consumer borrowing through mortgage equity withdrawal.

Of the Eurozone countries, a single one went this way very early in 1999–2000. That is the Netherlands. Its personal savings rate plunged from 13–14% to around 7% of disposable income. Since 2001, it is back up to 9–10%, but economic growth keeps hovering between recession and near-recession, compared to around 4% in the prior years.

As explained earlier, in the Eurozone, too, various countries have rampant house price bubbles. However, the big mortgage equity withdrawals remain missing.

We explicitly stress this fact because it pinpoints the main reason why the Anglo-Saxon economies have managed to outperform the Eurozone economies in the past few years. More or less deliberately and systematically, they choose bubble-driven economic growth.

It is a growth pattern that we fail to appreciate as a positive achievement. In addition, we are fearful of the highly probable painful ending of housing bubbles. The particular predicament is their extraordinary debt intensity: *first*, through construction financings; and *second*, through mortgage refinancing.

A recent historical study by the International Monetary Fund, titled “When Bubbles Burst,” states:

“The association between booms and busts was stronger for housing than for equity prices. The implied probability of a housing price boom being followed by a bust in the sample is about 40%. Housing and equity busts have, however, one important feature in common. During the 1970s to 1990s, they generally coincided or overlapped with recession.”

The study gives five reasons why housing bubbles are more dangerous than equity bubbles:

(1) “Housing price busts have larger wealth effects on consumption than do equity price busts.”

(2) “Housing price busts were associated with stronger and faster adverse effects on the banking system than equity price busts.”

(3) “Housing price busts were more likely to have been preceded by a boom so that there were larger imbalances to be unwound.”

(4) “Price spillovers across asset classes matter, as evidenced by the fact that housing price busts were more likely associated with generalized bear markets or even busts than equity price busts.”

(5) “Housing price busts were associated with tighter monetary policy than equity price busts.”

Reading this study of the International Monetary Fund about the differences between a housing bubble and an equity bubble, one must wonder whether it was a good idea on the part of the Greenspan Fed to fight the fallout from an equity bubble by creating a far more dangerous housing bubble. How will it cope soon when the bubble burts?

Mr. Greenspan made history as a central banker with his remark years ago that asset bubbles are perceptible only after they burst and that he, in any case, prefers to deal with the bubbles’ aftermath. He knew better in 1966, writing about the equity bubble in the late 1920s:

“The excess credit which the Fed pumped into the economy spilled over into the stock market — triggering a fantastic speculative boom. Belatedly, federal official attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late.

By 1929, the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a constant demoralizing of business confidence. As a result, the American economy collapsed.”

Of course, Mr. Greenspan is entitled to say that he knows better today. What particularly strikes us, though,

is that 40 years ago, he perfectly recognized the connection between "excess credit" and the speculative boom.

Searching his speeches over many years for mentioning of the word "credit," let alone the two words "credit excess," we note that these words have completely escaped his available vocabulary. Regarding his world records in credit excess, we understand why. More astonishing is their general complete absence in America's economic discussion.

MORE AND MORE DEBT FOR LESS AND LESS GROWTH

Austrian theory and ample practical experience warn that credit excess is the origin of every crisis. The U.S. credit excesses of the past few years definitely qualify as among the worst in history.

One crux is, of course, the measure of excess. The easiest and surest way to recognize an asset and credit bubble is to compare credit growth and simultaneous GDP growth. For decades after World War II, the two used to be closely linked. This began to change in the early 1980s. There emerged a persistent and growing "excess" of money and credit relative to GDP.

For some time, nobody took notice, discarding it as a harmless decline in money velocity. Yet it was soon realized that there existed a distinct connection between such "excess money" and rising asset prices. It proved, in fact, to be the beginning of the great equity bull market.

In its *World Economic Outlook* of April 1993, the International Monetary Fund published a study titled "Monetary Policy, Liberation and Asset Price Inflation." It said, this growing gap between GDP and credit growth could *"reflect a substantial shift in the pattern of transactions toward assets and other markets not captured in national income measures of final goods transactions. Viewed in this way, the money and credit gaps represent inflationary pressures in the economy."*

Meanwhile, such "excess money" is not only persistent, but in the United States it has also literally exploded. Additions to U.S. GDP have required more and more credit and debt generation over time.

Until the late 1970s, credit growth stayed in a narrow range around 140% of GDP growth. Lately, this ratio has approached 400%. In the first quarter of 2005, total credit growth of $2,976.1 billion compared with annualized nominal GDP growth of $787.6 billion.

Since credit essentially means debt, it is an ominous trend. Wondering about its cause or causes, we had no difficulty identifing them. This collapse in the relationship between credit growth and GDP growth results from a drastic change in the use of credit compared to past, normal times.

As we pointed out earlier, different kinds of expenditure impact the economy differently. The crucial fact to see about the soaring credit expansion in the United States is that less and less is financing economic activity. Easily the greatest part is used for purposes that add nothing to GDP: leveraged asset purchases and financial speculation, mergers and acquisitions, import surplus, stock buybacks and unpaid interests (Ponzi finance).

We estimate that these items together account for around three-quarters of total credit growth in the United States. Of course, this debt creation is also bare of any income creation.

In the end, all the U.S. GDP growth in the last few years has accrued from government and consumer spending, mainly the latter. This kind of spending, however, evaporates quickly in the economy, not to speak of the big drag from the huge import surplus.

Only two kinds of expenditure exert powerful demand and income effects, and that is building and business fixed investment. For sure, the housing bubble has bred many hundred thousand jobs directly through the building boom and indirectly through the frenzied activity of the real estate agents. But this has been offset by the downward pull on employment from the manufacturing sector on account of weak business fixed investment and the huge trade deficit.

AN INEVITABLE RECESSION

Not all asset and credit bubbles have ended in a terrifying bust. Yet some have. More than 10 years after the bursting of its real estate and investment bubbles, Japan is still struggling with murky economic growth. Four years after the bursting of their housing bubble, the Dutch are still struggling with recession.

As to the United States, there prevails a general blind faith that Mr. Greenspan with his geniality in monetary affairs will be sure to manage a soft landing for the economy and the markets.

The optimists point to past housing booms that ended without great harm. We think that any comparison with the past is misplaced because underlying macroeconomic conditions are diametrically weaker today. There never were such monstrous trade deficits, such protracted weakness in business fixed investment or such mountains of debt as today.

For us, by the way, the Fed's almost laughable caution in raising its federal funds rate is indicative of their low confidence in the economy's resilience and stability. Just think of the swiftness with which Paul Volcker pushed the rate close to 20% in 1979. Today everybody trembles at the thought that the rate might go to 4%. That tells you something of "new paradigm" strength.

SURPRISES FROM BRITAIN

Evidence of a sudden sharp economic slowdown is accumulating by the week in the U.K. bubble economy. Real GDO rose by 0.4% in the second quarter. The year-over-year growth rate was 1.7%, its lowest in 12 years, after 2.1% in the prior quarter. This compares with 3–3.5% predicted for the full year. The manufacturing sector is already recession, defined as two quarters of declining output. It was down 0.7% in the second quarter, after 0.9% in the prior quarter. Further downward revisions are expected.

The major factor behind the economy's slowdown is the cooling of the housing bubble reflecting flattened house price inflation since July 2004, and a sharp decline in mortgage equity extraction. Year-over-year, the value of retail sales rose in the second quarter just 0.4%, its smallest annual increase in the postwar period. When retailers slash their prices in desperation about sales, this raises real GDP.

All asset and credit bubbles end in one of two possible ways: through monetary tightening by the central bank, or monetary accommodation until the bubble bursts under its own weight and then fighting its aftermath — Mr. Greenspan's declared strategy. It prolongs bubble-driven growth but makes the endgame all the worse.

It is difficult to say what exactly pricked the U.K. housing bubble. The Bank of England has actually raised its repo rate since November 2003 in small steps from 3.5% to 4.75%.

Yet we think that the ability of consumers or businesses to extend their borrowing and spending excesses has its limits, irrespective of monetary policy.

THE AFTERMATH

The great question now is whether other spending components will jump in to offset a fading consumer borrowing-and-spending binge in the bubble economies. In our view, the chance of this is pretty bad. If business investment failed to recover strongly against the backdrop of booming consumer demand, we do not see why it should do so in the face of sharply declining consumer demand.

In the four years since 2000, private sector employment in England has risen 300,000, after 900,000 during the prior three years. Public sector jobs soared by 450 000. At the same time, the government heavily boosted spending on new schools and hospitals, spent more on drugs and schoolbooks, and employed more catering, cleaning and other private service contractors.

An article in the Financial Times from two research fellows at two University colleges pointed out *"that this public spending translated during 2000–03 to the creation of about 550 000 private sector jobs."* They closed their article: *"The experience of the last four or five years certainly does not support the idea that the*

United Kingdom's recent job growth has been the creation of a deregulated and vibrant private sector. A good old-fashioned Keynesian expansion seems much closer to the mark. Perhaps this is the lesson Europe should learn from the British experience."

This is, of course, precisely our persistent emphasis about the U.S. economy. Forget about super-efficient markets and new capitalistic flexibility and vibrancy as its new paradigm drivers. There never was a New Economy in the late 1990s. There has been no Goldilocks Economy in the past few years. There is a bubble economy.

CHINESE FEINT

On the whole, the announced change in China's exchange rate system has found kind approval, though most commentators have called it a far too small a step in the right direction. As Paul Krugmann wrote, *"There is a good chance that this is simply a piece of theater designed to buy a few month's respite from protectionist pressure in the U.S. Congress. Nevertheless, it could be the start of a process that will turn the world economy upside down."* The consensus read it as a symbolic step promising more to come.

In our view, it is much too foolish a step to give such promise. A 2% revaluation is much too small to exert any desired effect on trade balances. But for sure, it must whet the appetite of the international speculating community to bet on further revaluations, thereby triggering even greater floods of speculation than before, buying U.S. bonds. We suspect they have been advised by Mr. Greenspan.

On the Chinese part, it has been argued that their banking system is too weak to allow for major flexibility in the exchange rate. This is another utterly foolish argument. A weak banking system essentially arises from excess credit. As the Chinese central bank's huge dollar purchases correspondingly boost the liquid reserves of the country's banks, it stokes the credit excesses that undermine the banking system.

To us, this is precisely the road that Japan took in the late 1990s, however worse in its dimensions. What happens is that fixed investment, the country's capital stock, increases out of proportion to potential consumption. In due time, excess investment reveals itself as malinvestment. Bankrupting firms cause bankrupting banks.

By the way, it strikes us as very ominous that China's imports have drastically slowed while exports keep making ever-new records. Changes in imports are normally the earliest indicator of corresponding changes in domestic demand. We are more than doubtful about the validity of the stellar Chinese GDP growth data.

CHINA'S TRUE DILEMMA

An article in July 27's Wall Street Journal, titled "A Sea Change in China Triggered Yuan's Float," disclosed very interesting details about the elaborate investigations that the People's Bank of China undertook before implementing this change in its currency regime.

First, we would stress that the words "sea change" and "float" are gross parodies of what truly happened. Yet Mr. Greenspan and other U.S. policymakers quickly greeted the change with glee. For sure, they realized from the start that the whole thing was a farce and that the promise of more revaluations later could only accelerate capital inflows into China, implying even larger Chinese purchases of U.S. Treasury and agency bonds.

Remarkably, China's central bank undertook extensive studies about the benefits and detriments of a more flexible exchange-rate system, not only internally, but also externally, through consultations with the U.S. Federal Reserve and the Monetary Authority of Singapore. In May 2004, it hosted a conference about exchange-rate management with some of the top American economists in this matter, including Robert Mundell, Ronald McKinnon, Jeffrey Frankel and Morris Goldstein.

Mr. Mundell recommended continuing the peg, while the others recommended a change. At the end of the conference, a senior Chinese bank official stood up and said China planned to follow Mr. Mundell's advice in the short term and the advice of the others in the long term, but added, "Only we're not going to tell you how long the short term will be."

If the Chinese truly wanted to learn about the potential dire implications of a dollar peg, they ought to have invited the one central bank of a major country that faced exactly the same quandary in the late 1980s as China is facing today. That is the Bank of Japan.

All the talk about the yuan's undervaluation is really beside the point. The most important question is not raised at all. American policymakers and economists tend to emphasize the connection between an undervalued currency and the country's inflation rate. But China's dilemma is not an undervalued currency causing inflation. Its cardinal problem is — precisely as it was in Japan during the late 1980s — an excessive credit expansion disrupting the economy's demand-and-production structure, with excessive spending on real estate and manufacturing investment.

In short, it is about the monetary impact of China's dollar surplus.

Trying to protect its exporters, it is buying the dollar surplus at a fixed rate. In 2000, its dollar reserves amounted to $165.5 billion. Then, all of a sudden, these reserves began to explode. Lately, they exceeded $700 billion, up during the first half of this year at an annual rate of more than $200 billion.

By purchasing dollars, the central bank implicitly adds correspondingly to the banking system's reserves (high-powered money). Eager to make profitable use of this liquidity, the banks push their lending by a multiple amount. Since 2000, the essential result has been an explosive expansion of bank lending. As Austrian theory emphasizes, the trouble is that excess credit always flows unevenly into the economy. In the case of China, it is pouring into real estate and manufacturing investment, grossly overexpanding the two in relation to consumption.

What is happening in China is, in essence, a replay of Japan's real estate and investment bubble, though at relatively worse scale. It struck us: perhaps the Chinese know better than foreigners how vulnerable their economy really is.

CONCLUSIONS

If headlines are anything to go by, global economic growth was surprisingly strong in the second quarter, with the United States emerging out of a temporary soft patch. The rather ebullient stock markets seem to reflect this rosy perception.

Our reading is diametrically opposite. All the economies driven by housing bubbles are suddenly displaying weakness. Also, looking at the recent miserable performance of most commodity prices and the Baltic Dry Index, it increasingly appears that the global economy is far weaker than what the super bulls on the U.S. economy proclaim.

Stubbornly low long-term U.S. bond yields, in contrast, reflect an expectation that slower growth will force the Fed to stop and even reverse its rate hikes. We think that a dwindling housing bubble will reveal a much weaker U.S. economy than the consensus perceives. This could unleash cataclysmic effects on the dollar and all U.S. asset markets, including bonds.

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